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THE WHITE HOUSE
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CABINET AFFAIRS STAFFING MEMORANDUM

Date: April 2, 1984 **Number:** 168954CA **Due By:**

Subject: Cabinet Council on Economic Affairs - Tuesday, April 3, 1984 8:45 a.m. - Roosevelt Room TOPIC: Report of the Working Group on Federal Credit Policy

	Action	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☑	☐
Attorney General	☐	☑
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☑	☐
Transportation	☑	☐
Energy	☐	☑
Education	☐	☑
Counsellor	☑	☐
OMB	☑	☐
CIA	☐	☑
UN	☐	☑
USTR	☑	☐
GSA	☐	☐
EPA	☐	☐
OPM	☐	☐
VA	☐	☐
SBA	☐	☐

	Action	FYI
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
	☐	☐
	☐	☐
	☐	☐
Baker	☑	☐
Deaver	☐	☐
Darman *(For WH Staffing)*	☑	☐
Jenkins	☐	☑
Mc Farlane	☐	☑
Svahn	☑	☐
	☐	☐
	☐	☐
	☐	☐
	☐	☐
	☐	☐
CCCT/Gunn	☐	☐
CCEA/Porter	☑	☐
CCFA/	☐	☐
CCHR/Simmons	☐	☐
CCLP/Uhlmann	☐	☐
CCMA/Bledsoe	☐	☐
CCNRE/	☐	☐

REMARKS: The Cabinet Council on Economic Affairs will meet on Tuesday, April 3, 1984 at 8:45 a.m. in the Roosevelt Room.

The agenda and background papers are attached.

RETURN TO:

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☑ Tom Gibson
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THE WHITE HOUSE

WASHINGTON

March 30, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Papers for the April 3 Meeting

The agenda and papers for the April 3 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The Council will consider the report of the Working Group on Federal Credit Policy. The Working Group report will cover two issues. First, it will review the final draft of the Council's memorandum to the President regarding Trusts for Investment in Mortgages (TIMS). This memorandum, which was circulated to Council members following the last Council meeting on this subject, was revised to reflect comments by Council members. Second, the Council will consider the issue of whether the Administration should support privitization of FHLMC and, if so, whether previously-issued FHLMC obligations should continue to receive Federal backing. A paper from the Working Group on this issue is also attached.

Attachments

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

April 3, 1984

8:45 a.m.

Roosevelt Room

AGENDA

1. Report of the Working Group on Federal Credit Policy (CM # 113)

THE WHITE HOUSE

WASHINGTON

DRAFT

MEMORANDUM FOR THE PRESIDENT

FROM: THE CABINET COUNCIL ON ECONOMIC AFFAIRS

SUBJECT: Trusts for Investments in Mortgages (TIMs)

TIMs and the Secondary Mortgage Market

The financing of housing in the secondary mortgage market has increased sharply from $55 billion in 1981 to $110 billion in 1982 and an estimated $175 billion in 1983. About half of this financing is now in the form of securities backed by a pool of mortgages known as "mortgage-backed securities."

Until recently, a typical investor in a security backed by mortgages could not be certain of the term of his investment. If the mortgages underlying the mortgage-backed security are paid off early, as frequently occurs, then the mortgage-backed security must be paid off early also. Thus, a security backed by a pool of 30-year conventional mortgages might be largely paid back in 10-15 years. In contrast, an investor in corporate bonds is much more certain of the exact maturity of an investment. Investors are willing to accept a lower interest return to gain this certainty.

The TIMs proposal modifies the rules governing trusts that are tax exempt. It permits a trust to be set up that (1) holds mortgages, (2) issues securities backed by those mortgages, and (3) still provides investors with a certain term for their investments. The trust does this by reinvesting prepayments on the underlying mortgages instead of paying such prepayments directly to the securities holders and offering different rates of payouts appealing to different types of investors. Normally, such an "active" trust would be subject to tax; the TIMs proposal, however, allows the trust to be tax exempt. (The investors in the trust would pay taxes on their TIMs income.)

Since TIMs can provide a certain term to investors, it can offer some investors relatively short-term securities (e.g., three to seven-year securities) and other investors longer-term securities all backed by the same pool of mortgages. This makes TIMs a very attractive financing mechanism.

Federal Agencies in the Secondary Mortgage Market

About 62 percent of the secondary mortgage market is accounted for by three off-budget government sponsored agencies:

- o The Government National Mortgage Association (GNMA) is a wholly governmental unit within HUD. GNMA places a full faith and credit guaranty behind mortgage-backed trust certificates backed by pools of FHA/VA mortgages.

- o The Federal National Mortgage Association (FNMA) is a privately-owned corporation. The Federal Home Loan Mortgage Corporation (FHLMC) is a subsidiary of the privately-owned Federal Home Loan Banks. Both agencies issue mortgage-backed securities that do not have a full faith and credit guaranty but are considered "agency securities" because of Government supervision and sponsorship. This "agency security" status provides a considerable advantage in the marketplace. FHLMC is profitable and financially strong. FNMA is currently profitable, but has a large negative equity because of severe portfolio losses in the 1981-82 period of high interest rates.

Federal Credit Policy Goals

A credit policy goal of the Administration has been to reduce government agency activity in the secondary mortgage market and to increase private sector activity in that market. The TIMs proposal advances this goal by creating an investment security which can be competitive with corporate securities when issued by private sector issuers. The TIMs proposal could also contribute to this goal more directly by allowing private issuers of mortgage-backed securities to set up TIMs while not allowing the Federal agencies to do so.

The TIMs proposal could also contribute to limiting government agency credit by prohibiting TIMs from using government agency guaranteed mortgage-backed securities as collateral for a TIMs. Instead, TIMs would rely on the credit of the TIMs sponsor or on private mortgage insurance to insure the mortgages used as collateral in a TIMs.

TIMs and Housing

The CCEA Working Group on Federal Credit Policy has presented the TIMs proposal to the CCEA as a private market initiative intended to encourage private secondary mortgage activity while not encouraging more government agency activity. The housing industry, many Congressmen, and others, however, view the TIMs proposal as primarily a housing initiative. The TIMs idea, which was first proposed by your Commission on Housing in 1982, was seen as a way of increasing funds for housing through a more efficient secondary mortgage market.

Market developments during the past year have affected the way in which the TIMs proposal is viewed by the housing industry. When the proposal was advanced by the Commission on Housing in 1982, it was generally applauded and eagerly awaited by the housing industry. In June 1983, however, FHLMC introduced a mortgage-backed debt instrument with fast-pay, low pay classes known as Collateralized Mortgage Obligations (CMOs). This has been followed by more than $5 billion of private CMO issues. Most of these have been collateralized by GNMA mortgage-backed securities, but several recent issues have been backed by FNMA or FHLMC securities, or to a lesser extent, by privately insured mortgages. The result is that one of the major advantages of a TIMs -- creation of a mortgage-backed security with a certain or nearly certain term -- has largely already been achieved. This naturally leads the housing industry to focus more heavily on restrictions accompanying the TIMs proposal.

Those who see the TIMs proposal principally as a housing initiative argue in favor of government agency participation. Some argue that confining the proposal to the private secondary mortgage market diminishes its favorable impact on housing. Others point to the history of the agencies as market innovators and providers of market depth and liquidity and argue that the TIMs market may develop as fully without utilizing agency securities. Still others point in particular to the financial condition of FNMA and argue that TIMs could be an important tool for restructuring FNMA's portfolio.

If the TIMs proposal is designed as a private market initiative with limitations on government agency participation, its intended effect is primarily to reallocate the savings used for mortgages. That is, less of that savings would flow through government agencies and more would flow through private secondary mortgage market participants.

There is, however, a factual question, raised by the housing industry arguments noted above, as to how effective the TIMs proposal would be in stimulating additional private activity in the absence of any utilization of agency securities.

If the government agencies are allowed the advantage of TIMs, the principal effect would be a greater impetus to the housing industry. Such a housing proposal would allocate more of the total pool of U.S. savings into housing investments and away from business investment. It would, therefore, offset the effect of some of the increased incentives for business investment that we have provided.

Your decision is required on three issues: the first is whether to proceed with any TIMs legislation; the second and third deal with the extent of agency participation in TIMs.

Issue 1: Should the Administration submit TIMs legislation?

Option 1: Submit TIMs legislation.

Advantages

- The Administration has long been identified with the TIMs concept, has already testified in support of the concept, and has indicated that it would submit legislation. In particular, the Administration has made such commitments to Senators Garn and Tower, who introduced a TIMs bill of their own and have asked for an Administration bill.

- The TIMs proposal contains important advantages to segments of the housing industry that current market developments have not achieved.

Option 2: Do not submit TIMs legislation at this time.

Advantages

- Congress may allow government agencies access to TIMs whatever the content of the Administration's specific legislative proposal. This would frustrate achieving the Administration's longstanding objective of developing a private secondary mortgage market and would likely raise investment in housing at the expense of other sectors of the economy. Such a pro-housing bill would be difficult to oppose.

- With the growth and acceptance of CMOs, many of the advantages of TIMs for housing have already been achieved. Partly due to the development of CMOs and other financial innovations, the United States League of Savings Institutions argues that the housing finance industry does not need or want TIMs at the present time, and would prefer to have further study of the issue.

- The Administration already has implemented changes in regulations and has supported changes in banking and securities laws to facilitate the marketing of privately-issued mortgage backed securities.

Issue 2: Should any TIMs legislation allow government agency securities (guaranteed mortgage backed securities) to be used as collateral for TIMs?

Option 1: Allow government agency securities to be used as collateral for TIMs and CMOs.

Advantages

- o Government agency guarantees are less expensive than their substitute, private mortgage insurance. It also is doubtful that the private mortgage insurance industry would be capable of meeting a greatly increased demand soon. Permitting agency securities to be used as collateral will reduce the cost of TIMs arrangements and increase the amount of funds that can be raised through TIMs for housing.

- o Some form of utilization of agency securities may be necessary for development of the TIMs market. Without utilizing agency securities the TIMs market will develop more slowly.

Option 2: Prohibit government agency securities from being used as collateral for TIMs, but allow them to continue to be used as collateral for CMOs.

Advantages

- o This prohibition would keep the TIMs mechanism for the private sector alone, thus aiding the development of the private sector relative to the public sector.

- o By not applying any restrictions to CMOs, all of the current innovative financing would continue unrestricted.

Option 3: Prohibit government agency securities from being used as collateral for TIMs or for CMOs.

Advantage

- o This will limit most of the innovative financing mechanisms to the private sector and will encourage a marked substitution of private mortgage insurance for implicit Federal guarantees. This option would prohibit CMO transactions that have been occurring for the past six months.

Issue 3: Should any TIMs legislation allow government agencies to participate directly in TIMs arrangements?

Option 1: Allow government-sponsored agencies to issue or participate directly in TIMs arrangements.

Advantages

- Permitting government agencies to issue TIMs would provide the maximum assistance for rapid development of a TIMs market.
- The capacity to issue TIMs would provide FNMA with a tool to restructure its portfolio and improve its financial condition.
- Access to TIMs will enable the government-sponsored agencies to expand their credit activity in support of housing.

Option 2: Do not allow government-sponsored agencies to participate directly in TIMs arrangements.

Advantages:

- If both the government-sponsored agencies and the private sector have the same access to TIMs, then the existing advantage the government-sponsored agencies have in the market will frustrate the growth of the private sector.
- If government-sponsored housing credit is allowed to expand through TIMs, the implicit Federal credit liability will likely by increased significantly.
- Administration endorsement of full agency participation would undercut the private sector-oriented approach already advanced by Senators Garn and Tower and the efforts of the Bank Board to move FHLMC toward fully private status.

Decisions

Issue 1: Should the Administration submit TIMs legislation?

Option 1 __________ Submit TIMs legislation.

Supported by: Treasury, USTR, HUD, Labor

Option 2 __________ Do not submit TIMs legislation at this time.

Supported by: OMB

Issue 2: Should any TIMs legislation allow government agency securities (guaranteed mortgage backed securities) to be used as collateral for TIMs?

Option 1 __________ Allow government agency securities to be used as collateral for TIMs and CMOs.

Supported by: HUD, Labor

Option 2 __________ Prohibit government agency securities from being used as collateral for TIMs, but allow them to continue to be used as collateral for CMOs.

Supported by: USTR

Option 3 __________ Prohibit government agency securities from being used as collateral for TIMs or for CMOs.

Supported by: OMB, Treasury, CEA

Issue 3: Should any TIMs legislation allow government agencies to participate directly in TIMs arrangements?

Option 1 __________ Allow government-sponsored agencies to issue or participate directly in TIMs arrangements.

Supported by: HUD, USTR, Labor

Option 2 __________ Do not allow government-sponsored agencies to participate directly in TIMs arrangements.

Supported by: Treasury, OMB, CEA

Donald T. Regan
Chairman Pro Tempore

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

March 30, 1984

MEMORANDUM FOR: THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: THE WORKING GROUP ON FEDERAL CREDIT POLICY

SUBJECT: Privatization of the Federal Home Loan Mortage Corporation

On November 4, 1983, in testimony before the Senate Finance Committee on TIMs (Trusts for Investments in Mortgages), the Administration supported the taxation of FHLMC. Senator Dole has included the taxation of FHLMC as part of his tax bill. On March 15, 1984 Ed Gray, Chairman of the Federal Home Loan Bank Board (which also functions as the Board of Directors of FHLMC), wrote Senator Dole that "taxation without full privatization is inequitable." Chairman Gray recommended that taxation of FHLMC become effective only when (1) a majority of FHLMC's Board of Directors are elected by stockholders and (2) FHLMC's stock, which is currently held by the Federal Home Loan Banks, is distributed to the Banks' stockholders, member savings and loan associations. Although Senator Dole has rejected Chairman Gray's proposal to tie the effective date of FHLMC taxation to privatization, FHLMC taxation and Chairman Gray's support for full privatization present the Administration with a new opportunity to pursue the privatization of FHLMC.

Background

Over the past two and a half years, the Administration has made a strong commitment to control the growth of Federal credit, including the credit of government-sponsored enterprises. This basic credit policy objective has been a key element in the Working Group's discussion and analyses of TIMs and secondary mortgage market privatization alternatives.

The secondary mortgage market is dominated by three government agencies: the Federal National Mortgage Association (FNMA or Fannie Mae), the Government National Mortgage Association (GNMA or Ginnie Mae), and the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac).

FHLMC was chartered in 1970 to provide a secondary mortgage outlet for conventional mortgages (at that time, FNMA was still restricted to FHA/VA mortgages) serving mostly savings and loan associations. FHLMC is a wholly owned subsidiary of the Federal Home Loan Banks, which in turn are owned by member savings and loan associations. Unlike FNMA, FHLMC has not generally purchased mortgages for its own portfolio. Instead, FHLMC usually sells the mortgages it purchases using securities called participation certificates. This program has been very successful for FHLMC; in FY 1983, FHLMC had net income of $123.1 million, $54.2 billion of participation certificates outstanding, and only $6.9 billion of mortgages in portfolio.

In 1982, bills were introduced (with FHLMC's support) that would restructure and broaden FHLMC's ability to raise capital and reduce some of the ties that FHLMC has to the Federal Government. The Administration opposed these bills because they would have allowed for a substantial expansion of FHLMC's use of its Federal agency status. Instead, the Administration testified that FHLMC's good management and rising profits make it an excellent candidate for complete, not partial, privatization.

In discussing privatization, it is important to note that the secondary mortgage market can be divided into three distinct segments: the government-insured segment, the conforming (under $114,000) segment, and the nonconforming (over $114,000) segment. GNMA is restricted by law to government-insured mortgages and as a result of GNMA's "full faith and credit" guarantee, almost all mortgage-backed securities (MBSs) backed by government-insured mortgages sold in the secondary market are sold with GNMA guarantees. FNMA and FHLMC are restricted by law to conforming 1/ mortgages. Most conforming mortgages sold on the secondary market are sold through FNMA or FHLMC. Private MBS issuers can purchase any kind of mortgage for their securities, but, in fact, they are priced out of the government-insured and conforming segments of the secondary market. The conventional, nonconforming secondary mortgage market is relatively small, accounting for less than 8% of mortgages sold in the secondary market.

Privatization Questions

1. Should the Administration support the complete privatization of FHLMC?

Reasons to Support Privatization

-- Both the 1984 and 1985 Budgets state that the Administration is committed to the total privatization of FNMA and FHLMC.

1/ The dollar ceiling on mortgages eligible for purchase by FNMA and FHLMC increases each year in line with increases in average home prices. The base price was established in 1980 at $93,750 and has since been increased to $114,000. Unless the law were amended to provide an absolute dollar limit, the market share absorbed by FNMA and FHLMC could conceivably remain unchanged over the years at the possible expense of restricting the market share of private MBS users.

-- Privatizing FHLMC will reduce net lending by government-sponsored enterprises (GSEs) by $14.9 billion in FY 1985. This equals 34.7% of total GSE lending and 15.7% of total Federal and federally assisted lending in 1985.

-- If FHLMC continues to prosper as a private corporation -- and it should -- then a private FHLMC can demonstrate the acceptability of privatizing other GSEs, particularly FNMA.

-- The benefits of having two GSEs (FNMA and FHLMC) providing approximately the same services to approximately the same clientele are unclear. In particular, it is unclear what advantges, if any, are passed on to the consumer from the competition between FNMA and FHLMC in the conforming segment of the secondary mortgage market. Moreover, even if FNMA attempts to capitalize on its monopoly in the conventional, conforming segment should FHLMC be privatized, the Administration has the power through HUD to control FNMA's activities in a number of ways, and thus limit its use of its position.

-- Privatization would reduce Federal credit exposure, and thus potential Federal costs.

Reasons to Oppose Privatization

-- Unless the Administration actively limits FNMA activities, privatization of FHLMC may effectively eliminate FHLMC from the conventional conforming segment of the secondary market just as private issuers of mortgage-backed securities are effectively eliminated from this segment. As a result, FNMA may be able to increase its fees and its market share (which will help improve its financial condition) while the size and profits of FHLMC's activities decline.

-- Despite the severance of all ties between FHLMC and the Federal Government, investors may still prefer FHLMC's debt to that of other private corporations if they perceive a higher probability for Federal intervention in case of bankruptcy of FHLMC. Although this perception may permit FHLMC to compete, at least to some extent, with FNMA in the conforming segment, it may also enable FHLMC to drive private firms out of the nonconforming segment. Thus, it is possible to have a single firm in each of the three segments of the market: GNMA in the government-insured segment, FNMA in the conventional, conforming segment, and FHLMC in the conventional, nonconforming segment.

-- An Administration commitment to a privatization bill could well result in legislation which would reduce Federal control without a significant reduction in Federal benefits or Federal credit exposure.

-- Privatization may involve a very complex change because of the legal rights of FHLMC debt holders.

2. If the Administration supports the privatization of FHLMC, should previously issued FHLMC obligations continue to receive Federal backing?

Reasons to Discontinue Federal Backing

-- FHLMC is a profitable corporation with a healthy balance sheet. The firm has little exposure either to default or interest rate risk. There is no reason to expect FHLMC to have problems in meeting future obligations, and the disclaimers concerning Federal backing printed on FHLMC obligations may be vague enough to allow us to discontinue Federal backing. (Treasury's General Counsel staff is reviewing the legal implications of the disclaimers.)

-- The retention of Federal backing for previously issued FHLMC obligations may provide support for the perception that some ties between FHLMC and the Federal Government will continue to exist after privatization. Because this perception may enable FHLMC to drive out private firms from the nonconforming segment of the market, the Administration should take every step possible to minimize this perception.

Reasons to Continue Federal Backing

-- There may be a legal requirement that Federal backing be required.

-- Continuing Federal backing, even if we are not forced to do so, may make a privatization proposal more acceptable to Congress.

Table 1 — Major Federal Links for FNMA, FHLMC, and GNMA

Links	FNMA	Current FHLMC	Privatized FHLMC	GNMA
Factors Affecting Security Status				
U.S. Treasury Backstop..................	$2.25B	$4.0B 1/	None	2/
Legal Investment for Federally Supervised Institutions..........................	YesYes		Yes 3/	Yes
SEC Exemption..........................	Yes	Yes	Yes	Yes
Fed/FHL District Banks as Fiscal Agents.	Yes	Yes	No	Yes
Corporate Income Exempt from Federal Taxation..............................	No	Yes	No	Yes
Corporate Income Exempt from State/Local Income Tax............................	Yes	Yes	No 4/	Yes
Federal Supervision and Control				
Board of Directors.....................	5 of 15	3 of 3	None	2/
Government Approval to Issue Debt.......	Treasury	FHLBB	No	N/A
Oversight of Congress..................	Yes	Yes	No	Yes
General Regulatory Oversight...........	HUD	FHLBB	No	HUD
Agent for U.S. Policy..................	Yes	Yes	No	Yes

1/ FHLMC borrows from the FHL District Banks whenever necessary. The FHLB System has a $4 billion line of credit to the U.S. Treasury, at Treasury's option.

2/ These links to the Federal Government are, in effect, complete.

3/ The SEC exemption would be appropriate for FHLMC mortgage-backed securities but not FHLMC debt.

4/ Both FHLMC's and FNMA's exemptions ought to be repealed together to enhance the probability of competition in the conforming segment from a privatized FHLMC and other private firms.